

Internal Revenue Service  
**memorandum**

CC:TL-N-50-88

Br2:JMPanitch

date: JAN 20 1988

to: District Counsel, Salt Lake City  
Attn: Mark H. Howard

CC:SLC

from: Acting Director, Tax Litigation Division CC:TL

subject: [REDACTED]

The following analysis responds to Issue 2 of your request for technical advice, dated September 30, 1987. In a memorandum, dated December 23, 1987, CC:TL:Br1 responded separately to Issue 1 of your request.

ISSUE

Whether petitioners who filed a voluntary petition in bankruptcy under chapter VII of the Bankruptcy Act, 11 U.S.C. §§ 701-766 (1982) <sup>1</sup> were entitled to deduct on their [REDACTED] joint income tax return any portion of the net operating loss incurred by their wholly-owned subchapter S corporation, [REDACTED] for its fiscal year ended [REDACTED].

CONCLUSION

The corporation's subchapter S election did not terminate upon either the filing of the [REDACTED] personal petition in bankruptcy, the filing of the corporation's petition in proceedings under chapter XI or the conversion of the chapter XI proceedings to proceedings under chapter VII. Furthermore, the corporation's taxable year did not end prior to [REDACTED] unless the corporation underwent dissolution under state law or complete liquidation. Since neither of these events occurred in [REDACTED] the [REDACTED] are not entitled to claim any portion of the corporation's

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<sup>1</sup> All references are to the Bankruptcy Act and the Internal Revenue Code as in effect during the years in issue, unless otherwise stated.

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net operating loss deduction on their [REDACTED] joint income tax return.<sup>2</sup>

#### FACTS

Petitioners, [REDACTED] and [REDACTED], filed a voluntary petition in bankruptcy under chapter VII of the Bankruptcy Act, 11 U.S.C. §§ 701-766 (1982), on [REDACTED]. [REDACTED] was the "principal owner" of [REDACTED], a subchapter S corporation. [REDACTED] (hereinafter "the corporation") was a [REDACTED] fiscal year taxpayer. [REDACTED]'s shares of the corporation were among the assets listed on the [REDACTED]'s bankruptcy petition. The corporation originally filed a petition under chapter XI in [REDACTED]. The chapter XI proceeding was converted to a chapter VII proceeding in bankruptcy on [REDACTED].<sup>3</sup>

On their return for the taxable year [REDACTED], husband and wife claimed losses of \$ [REDACTED] from the corporation's fiscal year ending [REDACTED]. The [REDACTED] were discharged in bankruptcy on [REDACTED].

#### ANALYSIS

Section 1371(a)(2) provides that a small business corporation is a domestic corporation which is not a member of an affiliated group, and which does not have as a shareholder a person (other than an estate) who is not an individual. Section 1371(f)<sup>4</sup> provides that the term "estate", as it appears in

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<sup>2</sup> Since the corporation did not file its bankruptcy petition until [REDACTED], we have assumed that neither dissolution nor liquidation took place in [REDACTED].

<sup>3</sup> Based on conversations with Mark Howard, we understand that the facts surrounding the corporation's bankruptcy are difficult to ascertain. If any of our assumptions prove to be incorrect, please notify us so that we may rework our analysis accordingly.

<sup>4</sup> Section 5(d) of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389, (hereinafter "the Act") amended section 1371 to include the estate of a bankrupt individual among the ranks of qualified shareholders of subchapter S corporations. Section 7(d)(4) of the Act makes section 5(d) of the Act effective in any bankruptcy case commenced on or after October 1, 1979. Since the [REDACTED] filed their petition in bankruptcy on [REDACTED] (continued...)

section 1371(a)(2), includes the estate of an individual in bankruptcy. Section 1372(e)(1) provides that a corporation's subchapter S election will terminate if a person who was not a shareholder on the day the election was made becomes a shareholder and affirmatively refuses to consent to the subchapter S election on or before the 60th day after the date upon which the shareholder acquires the stock. Section 1372(e)(3) provides that a corporation's subchapter S election terminates when the corporation ceases to be a small business corporation under section 1371(a). This termination is effective for the taxable year in which the corporation ceases to be a small business corporation and for all succeeding taxable years. Section 1374(b) allows shareholders of a subchapter S corporation to deduct a pro rata portion of the corporation's net operating loss (based on a per share, per day allocation) for the shareholder's taxable year within which the taxable year of the corporation ends.

Section 443(a)(2) requires a taxpayer to file a return for a period of less than 12 months if the taxpayer is in existence during only part of what would otherwise be its taxable year. Treas. Reg. § 1.443-1(a)(2) provides, in part, that "a dissolving corporation which files its returns for the calendar year is required to file a return for the short period from January 1 to the date it goes out of existence."

In the present case, since the [REDACTED]'s estate in bankruptcy was a qualified shareholder under section 1371(f), the filing of the [REDACTED] chapter VII bankruptcy petition did not terminate the corporation's subchapter S election.

Assuming that the trustee of the [REDACTED] estate in bankruptcy did not affirmatively refuse to consent to the subchapter S election, the election survived the transfer of the stock from [REDACTED] to the [REDACTED] bankruptcy estate. Section 1372(e)(1).

A corporation's subchapter S election does not terminate either when the corporation files a petition in bankruptcy or when the corporation is adjudicated bankrupt. See Abdallah v. Commissioner, 69 T.C. 697 (1978), aff'd 647 F.2d 487 (5th Cir. 1981); Mason v. Commissioner, 68 T.C. 163 (1977), aff'd per curiam, 1980-2 U.S.T.C. para. 9665 (9th Cir. 1980). In Abdallah, two subchapter S corporations, whose taxable years ended January 31, 1967, were adjudicated bankrupt on October 26, 1966. The Tax Court held that the portion of the net operating losses which the corporations had incurred in the 1966-1967 fiscal year prior to

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<sup>4</sup>(...continued)

[REDACTED] the amendment to section 1371 which is contained in section 5(d) of the Act applies in the present case.

October 26, 1966, passed through to the shareholder in the shareholder's 1967 taxable year, pursuant to section 1374. In so holding, the Tax Court noted that the parties had not raised the issue of the validity of the corporation's subchapter S elections for the taxable years involved. Abdallah, at p. 700. <sup>5</sup> In Mason, a subchapter S corporation, which maintained its books and records and reported its income on a calendar year basis, filed a voluntary petition in bankruptcy on January 17, 1967, and was apparently adjudicated bankrupt on the same date. The trustee in bankruptcy sold some of the subchapter S corporation's equipment and relinquished the rest to secured lienholders. The corporation was discharged in bankruptcy on August 17, 1967, and on August 1, 1969, the corporation's bankruptcy was closed by order of the bankruptcy court. The Tax Court held that the net operating loss which the corporation had incurred in 1967 passed through to the sole shareholder pursuant to section 1374. In both Abdallah and Mason, if the corporation's petition in bankruptcy or the adjudication of the corporation as being bankrupt had terminated the corporation's subchapter S election, then the Tax Court would have held that no portion of the net operating losses could pass through to the shareholders. Section 1372(e)(3). See, Osborne v. Commissioner, 55 T.C. 329 (1970) (Subchapter S corporation received sufficient passive investment income to terminate its subchapter S election under section 1372(e)(5); shareholders were not entitled to deduct any portion of corporation's net operating loss on their income tax returns for their taxable year within which the corporation's taxable year ended); Johnston v. Commissioner, T.C.M. 1976-142 (Similar to Osborne).

In the present case, given that neither the individual's petition in bankruptcy nor the corporation's petition and later adjudication in bankruptcy caused the corporation's subchapter S election to terminate, the corporation's net operating loss must have passed through to a shareholder of the corporation, pursuant to section 1374. The loss would pass through in the shareholder's taxable year within which the corporation's taxable year ended. The [REDACTED] apparently claim that the corporation's taxable year began on [REDACTED], and ended on [REDACTED], when the corporation's chapter XI proceeding was converted to a proceeding under chapter VII. The mere filing of a petition in bankruptcy under chapter VII does not terminate a corporation's taxable year. Rather, the corporation's taxable year ends on the last day of the corporation's calendar or fiscal year, unless dissolution under state law or complete liquidation occurs prior thereto. See Section 443(a)(2); Treas. Reg. § 1.443-

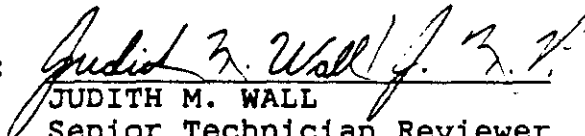
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<sup>5</sup> Apparently, neither the Commissioner nor the Abdallahs viewed the bankruptcy as having any effect on the subchapter S election, except insofar as it established the worthlessness of the corporation's stock.

1(a)(2); Rev. Rul. 71-129, 1971-1 C.B. 397; Klein v. Commissioner, 75 T.C. 298,301 at note 6 (1980); Abdallah v. Commissioner, 69 T.C. 697 (1978), aff'd 647 F.2d 487 (5th Cir. 1981). Thus, unless the corporation was either dissolved or completely liquidated in [REDACTED], its taxable year did not end until some time in [REDACTED]. Then, regardless of who should properly have reported the net operating loss, said loss was not properly reportable until [REDACTED] Section 1374. The questions concerning when the corporation dissolved under state law and when the corporation was completely liquidated are factual inquiries which must be resolved.

In conclusion, the [REDACTED] were not entitled to deduct (on their [REDACTED] joint income tax return) any portion of the corporation's net operating loss for its fiscal year ended [REDACTED]. This is so, because neither the corporation's subchapter S election nor its taxable year ended in [REDACTED]. Therefore, we recommend that the respondent's answer be amended to assert an increased deficiency for the [REDACTED] improper deduction in [REDACTED] of the corporation's net operating loss incurred for the fiscal year ended [REDACTED].

PATRICK J. DOWLING

By:   
JUDITH M. WALL  
Senior Technician Reviewer  
Branch No. 2  
Tax Litigation Division